RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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**Nov. 9, 1994** **LETTER 1160**

**THE PICTURE: Question:** Russell, I don't get it. You've been talking "primary bear market" ever since your "Special" bear market mailing of April 1. But let's face it, business is good, corporate earnings are excellent, employment is up, unemployment is down, inflation seems to be under control, and factory capacity is pressing against the ceiling. How can this all lead to a bear market?

**Answer:** I may talk a lot about business and the economy, but what I sell is **investment advice.** I don't care if corporate earnings have climbed into the stratosphere, I deal with **price action, Dow Theory, technicals, trends.** Listen, if earnings at the corporation you work for are booming, that's great, and you'll probably get a raise. But that's not what I'm interested in. What I am interested in is the price action and the trend of your corporation's stock.

Right now, corporate earnings in the US are very good, actually much better than analysts expected as recently as six months ago. But look at my **Primary Trend Index** (page 2 chart); it hit a new bear market low on November 4. Study the **advance-decline ratio** (which is a proxy for the action of all the stocks on the NYSE). The A-D ratio hit a new bear market low on the same day, November 2. Now check the daily new highs and lows. New lows have been coming in heavily, with day after day of more new lows than new highs.

My subscribers and I don't make money during periods when corporate earnings are up. We make money in periods when our stocks are up. By the same token we don't lose money during periods when corporate earnings are down. We lose money during periods when our stocks are down.

Back in 1946 *Time* magazine featured a fascinating article about a brand new automobile company, Kaiser-Frasier. The brains behind this company was a famous and successful financier, Henry J. Kaiser. Kaiser had been one of the great suppliers of materiel during World War II. He was an inspiration to the nation. I read and re-read that *Time* article. It stated that the new Kaiser car was sure to give GM and Ford a run for their money. It would be the first new car of the Post-War period.

I asked myself, "Now could anyone go wrong with Kaiser stock?" I bought 300 shares at 24. A year later the stock was under 10, and I was poorer and very mystified. But I was determined to find out why and how I had gone wrong. The stock market had to make sense to me or I would never buy a stock again.

I spent days, weeks, months in the superb economics room of the 42nd Street New York Public Library. Nothing I read told me what I wanted to know. I continued to read. Finally, by pure luck or perhaps through the process of elimination I happened on a collection of investment reports by Robert Rhea, the great Dow Theorist of the 1930s. I was fascinated with Rhea's writings. It was my first introduction to trends and technical analysis and Dow Theory.

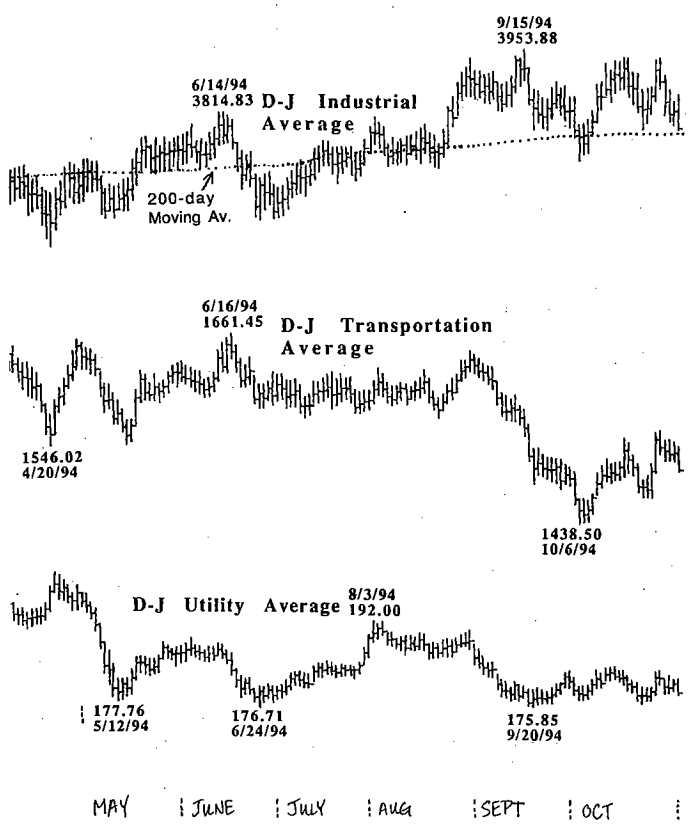
Of course, I continued to read the news of the day and the hype and the hopes (as I still do today); I also learned to disregard the news of the day and the hype and the hopes, and to **concentrate on the action of the market itself.**

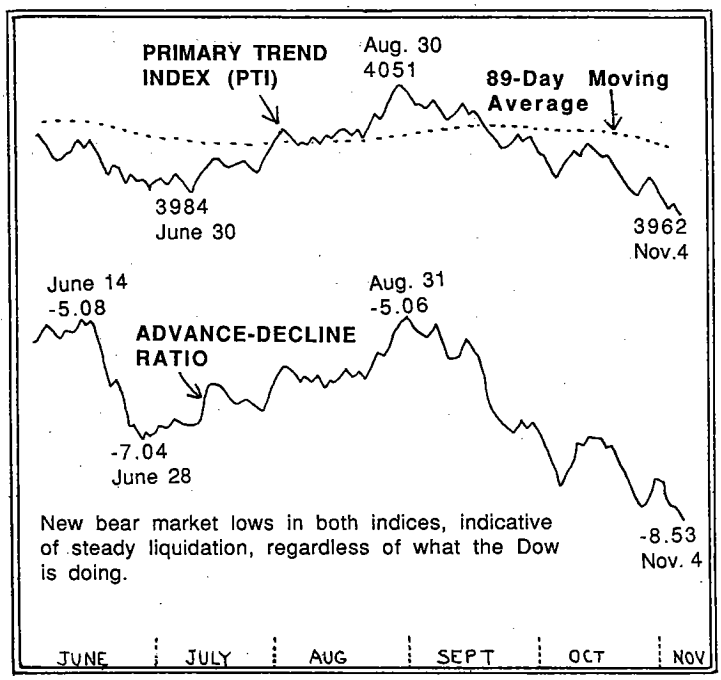
**Oct. 28 DJIA 3930.66; PTI 3988; A-D Ratio -7.76**
**Nov. 4 DJIA 3807.52; PTI 3962; A-D Ratio -8.53**
**Dow Yield: 2.78%; Dow Price/Earnings: 18.7**
**Dow 200-day MA: 3795; Dow 30-day MA: 3863**
**Dow Times Book Value: 3.40; PTI 89-day MA: 4008**
**Percentage of Undervalued Blue-chips: 10%**
**Dow Low Risk Buy Index: +39; Gold-PTI: 902**
**Gold 200-day MA: 384.65**

During the late-40s I read every market book that I could get my hands on. Schabacker, Gann, Drew, Rhea, Edwards, Magee, Schaefer, Hamilton, Dow; I lived, ate and dreamed the writings of these great stock market pioneers. Finally, during the late '50s I decided to write my own stock market report. And that's how *Dow Theory Letters* got started.

So much for history. Now, to get back to the current market. Obviously, stocks are, and have been, marching to a different drummer -- not the cheerful drummer you read about in the newspapers. No, the drum beat they've been marching to is the beat, beat, beat of the bear.

The bear's been in the "Investment Position" box ever since the special mailing, the "Bear Market Letter" of April 1. And yes, I'm well aware that a lot of subscribers have been skeptical about the bear in the box. The business news has been just too rosy, too optimistic. How could a bear market have arrived? But ever since early-April I've tried to show my subscribers that the underpinnings, the technical sub-structure of this market, have been gradually deteriorating.






The bearish hints may have been subtle at first, but they were there. I described the Dow Theory bear signal of March 31. I showed my PTI heading due south. I showed the **A-D Ratio** breaking down to low after low. I pointed to the very comprehensive **NYSE Financial Index,** which was also breaking down. I talked about the vulnerability of an almost ridiculous parade of 5,000 mutual funds. And I discussed the public's crazy, lemming-like rush into the funds.

Now I come to more speculative thoughts. It's possible, as the great majority of analysts claim, that what we've been experiencing is simply a correction in a great, continuing bull market.

It's possible, but I don't think so. I think we're in the **first phase** of a major bear market. I base this partly on my own (perhaps egotistical) market instinct. I also base it on the fact that the stock market has been overvalued for a very long time. Never in history has the yield on the Dow or the S&P remained below 3% for two-and-a-half years. Never has a bull market lasted 20 years (since 1974 by my reckoning). Never has a bull market sopped up so much public money. Never has a nation or its people built such a giant edifice of debt. And finally, never has the Federal Reserve allowed such a colossal credit bubble to be built.

The first phase of the bear market has been in progress since last February. Since then most stocks have been going down, but the psychology of the public and most professionals has remained stubbornly **bullish and hopeful.** This is typical and characteristic of the first phase of a bear market.

But somewhere ahead the damage to stocks and bonds will finally turn investors' sentiment bearish. Somewhere ahead the **huge losses** in stocks and bonds are going to impact on the psyche of the American public. And remember, American consumers (currently up to their necks in debt) generate roughly two-thirds of the nation's Gross Domestic Product. When all the above takes place, the bear market will be moving into its second and longest phase. And losses will accelerate.

The second phase of the bear market will be characterized by stocks declining as they reflect obvious deterioration in the economic, social and political fabric of the nation. When that happens, pessimism will rise, customers' brokerage and bank accounts will be decimated, and business will turn ominously bad. During the second phase, the fact that a primary bear market exists will finally be recognized and accepted.

Now I obviously can't predict the exact root causes of this bear market. I suspect the bear market will have a background of severe dollar weakness. I suspect the debt situation will turn deadly. I suspect that foreign competition will have a hand. I suspect that interest rates will be a factor. I can almost guarantee that adverse corporate earnings will be a factor.

**BEAR MARKET RALLIES:** ***"In a primary bear market the rallies are apt to be violent and erratic, and always occupy less time than the decline which they partially recover."*** William Hamilton, *Wall Street Journal* editor and pioneering Dow Theorist.

The broad trend of the market (based on my PTI and based on the all-inclusive advance-decline ratio) has been down ever since last February. That's eight months of downside action. During those eight long months a lot of damage has been done. **But even bear markets get tired of going down.** Newspapers start featuring negative stories. Downside compression builds. Too many traders assume bear positions. Too many investors get hurt and become discouraged. Too many short sellers put out too many shorts. When all of this happens, the bear obligingly steps back, and we get an upside correction (often, an explosive one).

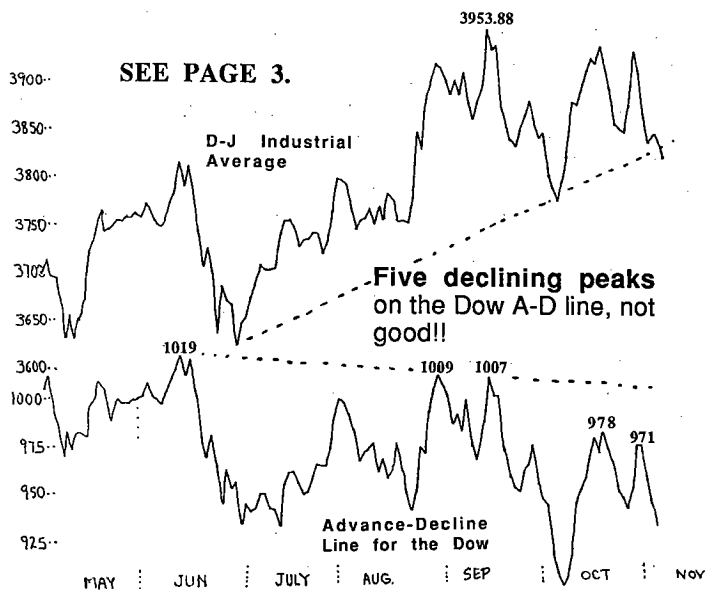
Along these lines I've been thinking -- there's been one glaring "glitch" in the bear picture. And it's this -- despite the losses in the great majority of stocks, the Dow has continued to hold to within a few percentage points of its all time high. Strange. Unusual. What does it mean? Here are my thoughts.

**THE FINAL TOUCH?** Sometimes the market needs that "final technical touch" before the dominant (primary) trend is ready to reveal itself clearly and unequivocally. And I've wondered if the gods of the market won't be satisfied until we get that ultimate technical anomaly -- a new high on the Dow above **3978.36** -- a high that would almost surely be **unconfirmed** by the Transports, the Utilities, the A-D ratio, the PTI, and almost everything else for that matter.

Yes, I've wondered whether the Dow won't make that last trip to the highs before we experience the real trouble, the dramatic trouble that will tell everyone that this is indeed a primary bear market. So far, many investors have felt that it "might be" a bear market. They've felt it through their losses in mutual funds, losses in bonds, losses in most stocks and in the dollar. But until the Dow itself heads down in earnest, Wall Street pundits will still be able (with a straight face) to tell us that what we've been experiencing is "just a reaction," a period of "adjustment" in a bull market that is fated to stretch ever-higher.

So let me put it this way, I place the odds for a final (unconfirmed) high by the Dow at around 50/50. If it does happen, let's not be surprised. But remember, it's still a bear market.

SEE PAGE 3.



**DOW:** The Dow and its own advance-decline line continue to provide potential technical problems (chart, bottom of page 2). You can see that since June the trend of the Dow has been up while the trend of the Dow's own A-D line has been down. Note that the Dow A-D line has traced out a series of five declining peaks. This tells us that fewer and fewer individual Dow stocks are responsible for the Dow's rising trend, and, of course, this is a negative technical development.

What I'm watching for now is a possible Dow surge above the September peak of 3953.88. If this occurs, it will probably NOT be confirmed by the Dow A-D. Such action would just add another segment to the already lengthy list of technical non-confirmations.

**INVESTMENT POSITION:** No sense in entering a lengthy discussion here. The bear's in the box. Market deterioration continues, despite all the "good news" on the corporate front. And our position is the same -- out of common stocks, out of bonds, and into liquidity. Liquidity means cash, which in turn means short-term paper, be it of the US, Swiss, Japanese or German variety. For most Americans the easiest and safest liquidity position is US T-bills. Or a money market fund or the shortest-term T-bills or even tax-anticipation notes from your state.

Gold remains in a state of "suspended animation." My gold item of choice is gold coins -- they are the **ultimate form of liquidity.** I prefer Krugerrands because of their low premium over actual gold content. If inflation is "just around the corner," which I doubt, then bonds will sink further and rising rates will tend to hold gold back. If deflation lies somewhere ahead (which I suspect), then we'll be facing more problems and troubles than we know what to do with. Deflation will mean that the viability of the dollar will be questioned, in which case, gold will come into its own -- as the ultimate (and maybe the only) island of safety in a rudderless world of suspect currencies (see Gold section).

**NOTES & QUOTES:** There's no question about it -- 1994 has been a "horror year" for the **dollar.** Some statistics, all spot -- Dec. 31, 1993 to October 25, 1994: Swiss franc up 19.4% against the dollar; Swedish krona up 18.4%; Belgian franc up 17.9%; Danish krona up 16.5%; D-mark up 16.4%; French franc up 15.8%; Japanese yen up 15.6%; Spanish peseta up 15.0%; Italian lira up 12.4%; Sterling up 10.9%; Aussie dollar up 8.4%.

Something new is impacting on the dollar. Americans have been big investors overseas, and the positive flow of dividends, profits and interest was an offset to our negative trade balance. But the situation is changing. America's net foreign debt, now over $500 billion, is starting to switch the equation, meaning that it is starting to add to our trade deficit figures. Economists at McGraw-Hill estimate that within a year the income shortfall will reach $20 billion, and this will add downward pressure to the dollar and upward pressure to interest rates.

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The sad plight of the **British "royals"** is proving to be a boon for the tabloids in both Britain and the US. The US tabloids have already enjoyed a bonanza with O. J. -- since the O. J. coverage began *National Enquirer's* circulation has increased by a whopping half a million readers. Said the *NY Times* in an editorial entitled, "Whining Towards the Throne," it was Murdoch's *Sunday Times* that published the Prince's caddish declaration that he never loved his wife and anyway his daddy frightened him into marrying her. Also, his mother was distant and the boys at his perfectly awful school picked on him. Today, the Prince is expected to offer his authorized version of his affair with Camilla Parker Bowles. **Russell comment:** In view of all this, Britons are debating the wisdom of retaining the royals at all. Why keep them? Answer: evidently, you keep them for the amusement of the British and American press. In the meantime, a French magazine reported two weeks ago that Charles and Di would divorce early next year with Di receiving a $25 million settlement. Charles immediately denied that there would be a divorce. The magazine quoted Di as saying, "I'm a P.O.W., a prisoner of Wales."

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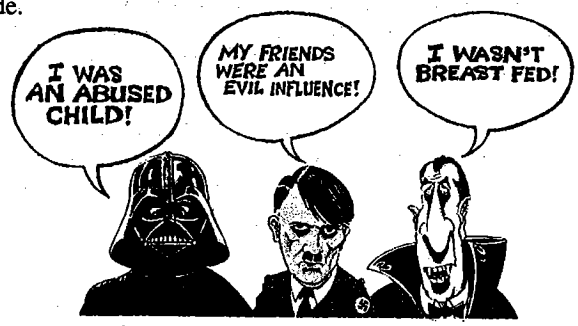
**Avoiding responsibility** seems to be the chief preoccupation of most of the English speaking race. The US law courts are chock full of criminals who claim, "I did it because I had a miserable childhood." But when it comes to **rights**, the boys and girls make no excuses -- they're damn well entitled to them. And they want the government to provide for them. Is there anything people need or want today that the government doesn't consider a right? This may be the biggest philosophical and economic question of the decade.

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Clinton is talking about his good deal in N. Korea, and boasts that as a result "the whole world will be safer." But Safire in the *NY Times* writes (Oct. 24), *"The (arms) inspectors are seething at the US cave-in and the precedent set for future blackmail."* James Schlesinger, former chairman of the A.E.C. and later Carter's Energy Secretary said, *"While it was not an unconditional surrender, it was a negotiated surrender."* Wrote columnist Paul Greenberg, *"At last the Clinton Administration has learned how to handle a devious dictator bent on wielding nuclear weapons: give him what he wants and declare victory."*

Then there was the embarrassing pay-off to General Cedras to get him out of Haiti. That one, I felt, smelled to high heaven and wasn't necessary. As far as the big build-up in Kuwait, more hot-dogging prior to the election (I didn't think we needed anything like that giant show of strength to move Saddam back inside Iraq again). By the way, Bush's amazing goof in not destroying Saddam's Republican Guard and finishing off the war in Iraq now becomes patently clear.

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**American TV** Invades the World: better believe it. Faced with fading opportunities in the US the biggies (Viacom, Time Warner, Fox, Disney) are all rushing to stake claims in overseas TV networks. Even US telephone companies such as Nynex and US West are testing the overseas waters. So despite a miasma of conflicting law in various countries, the TV networks are snapping up minority ownership in local satellite and cable TV channels. Our biggest export continues to be American culture, and it's via films and TV with much more to come.

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**Who Are They?** *Vogue* magazine (November) states, "These days, there's no working actress who doesn't have a plastic surgeon, and they're making small changes all the time." *Vogue* quotes one plastic surgeon as saying that "surgery usually begins at 30; older (plus 40) actresses probably have their noses done three or four times. And getting your lips done is like making a hair appointment." Then *Vogue* asks, "Is that why so many actresses are looking either like a wax-museum piece with no resemblance to their former self (Cher, Roseanne, Melanie Griffith) or uncannily like someone else (is it Anne Archer or Kim Basinger)? Then again, maybe they all have the same trainer."

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This from Presidential contender (Libertarian Party) Harry Browne. "I can remember when the California legislature met for a few months in the odd-numbered years. A two-year budget was passed, along with some new laws. Then the legislators went home to their private-sector jobs and forgot about politics until the next election season a year later. I haven't been able to verify it, but I seem to remember they were paid a stipend of less than $10,000,

plus travel expenses, for a two-year session of the legislature. Then someone got the brilliant idea that government would be improved if we paid legislators full-time salaries. Just think: we could attract the best and the brightest thinkers to state government. So now legislators get $52,000 per year (plus innumerable benefits and expense accounts) and they are full-time, lifetime burdens on society. Not surprisingly, the state budget has exploded -- from less than $1 billion a year to over $100 billion."

You've got it right, Harry. And what do you think is the major goal of every politician? Clearly, it's to get re-elected and then re-elected and re-elected. I asked my savvy lawyer wife, Faye, why politicians are so crazy all-fired intent on being re-elected. Quothe Faye, "It's because most of them don't know how to do anything else." And I'm afraid she's right.

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**Keep Thinking:** New research on the brain pioneered by Dr. Marian Diamond at Berkeley shows that the amazing brain can thrive -- and actually get better with age. She suggests thinking of the brain as a muscle. The more you exercise it, the better it functions. So-called "brain power" is linked directly to the number of dendrites we have at our disposal. Dendrites are nerve cell extensions, and they receive incoming information. When we think, the dendrites branch out, and this branching brings about millions of new connections between nerve cells. The connections are called synapses. Let's put it this way -- the more thinking, especially **new** thinking, the more brain "exercise," the more synapse connections and the better condition the brain is in.

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**Root for Newt?** Then you better know something about him. Newt Gingrich is the fiery 51-year old former assistant professor of history at West Georgia College, elected to Congress in 1978 on his third try. If the Republicans win control of the House, Newt Gingrich of Georgia will become majority leader and Speaker of the House. If that happens, all hell should break lose. Newt promises to use "subpoena power" to create a select committee on corruption to investigate the Clinton administration. Furthermore, in his stump speech Gingrich talks about five megatrends sweeping the globe that will help demolish the existing liberal power structure. The megatrends are (1) the coming of the information age, (2) the development of the world market, (3) the gradual demise of the welfare state and the arrival of the opportunity society, (4) the emergence of citizen politicians to replace the professional class now in power, and (5) what he describes as the belief in "American exceptionalism" over counterculture values.

Says Gingrich, "I think I am a transformational figure. I think I am trying to effect a change so large that the people who would be hurt by the change --the liberal, Democratic machine -- have a natural reaction, which gets wearying sometimes." Gingrich calls Clinton "the enemy of normal Americans." Dems shudder at the thought of Newt at the helm. "I clearly fascinate them," snaps Gingrich, "I'm more intense, much more persistent, much more willing to take risks to get it done. Since they think it is their job to run the plantation, it shocks them that I'm actually willing to lead the slave rebellion."

In another speech Newt warns, "It's impossible to maintain a civilization with 12-year olds having babies, 15-year olds killing each other, 17-year olds dying of AIDS, and 18-year olds getting diplomas they can't read." He attributes most of society's troubles to the "counterculture" which, he says, "permeates this Administration." He adds, "We're prepared to place our trust in the people to reshape the government; our liberal friends place their trust in the government to reshape the people." **Russell Comment**: Sounds like Newt has studied the Constitution and believes what it says.

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More Washington: In a memo, Alice Rivlin, head of the Office of Management and Budget, projects a nearly 50% jump in the federal deficit by the year 2000. She also notes that "there is unlikely to be much more room" for discretionary spending cuts. Rivlin estimates that it would take $689 billion in new taxes or spending cuts over five years to balance the budget. **Russell comment:** With the national debt pushing rapidly towards $5 trillion and the country adding $300 billion a year additional to the debt, the problem is mind-boggling.

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**Bear Signs:** "Guru" Elaine Garzarelli exits from Lehman. Public radio star Louis Rukeyser starts a second market advisory, this time on mutual funds. All this as Wall Street "trims its sales," meaning they're laying off brokers.

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**Believe What You See?** From the London *Financial Times:* "Forget the adage that the camera never lies. The latest generation of image editing software makes it possible to alter photographs directly so well that is is virtually impossible to spot the change. This technology is creating an entirely new image-editing industry -- and raising legal and social questions. Unlike traditional methods of re-touching photos, which require considerable skills, in digital image editing most of the hard work is done using a system costing only a few thousand dollars. Photos can also be altered to change features -- people can be made thinner, fatter, or younger. They can acquire a firmer chin or lose a scar. A normal person would never be able to tell the difference. If it's a good picture to start with, the blending is seamless."

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**Only In La Jolla**: Last week two BMWs collided in mid-town La Jolla. A pedestrian who saw the crash reported, "It was really a nasty one. One BMW driver dropped his cellular phone; the other one spilled his cappuccino all over himself."

**AH PERFECTION:** Strange, but the most popular, the most widely-requested, and most widely quoted piece I ever wrote was not about the stock market -- it was about business, and specifically about the theoretical "ideal business." I first published this piece in the early-1970s. I repeated it in Letter 881 and then again in Letter 982. I added a few thoughts in each successive piece. But seldom does a month go by when I don't get requests from subscribers or from some publication to republish "the ideal business." So here it is . . .

I once asked a friend, a prominent New York corporate lawyer, "Dave, in all your years of experience, what was the single best business you have ever come across?" Without hesitation, the lawyer answered, "I have a client whose sole business is manufacturing a chemical that is critical in making synthetic rubber. This chemical is used in very small quantities in rubber manufacturing, but it is absolutely essential and can be used in only super-refined form.

"My client is the only one who manufactures this chemical. He therefore owns a virtual monopoly since this chemical is extremely difficult to manufacture and not enough of it is used to warrant another company competing with him. Furthermore, since the rubber companies need only small quantities of this chemical, they don't particularly care what they pay for it -- as long as it meets their very demanding specifications. My client is a millionaire many times over, and his business is the best I've ever come across." I was fascinated by the lawyer's story, and I never forgot it.

When I was a young man and just out of college my father gave me a few words of advice. Dad had been in the paper manufacturing business; he had been assistant to Mr. Sam Bloomingdale (of Bloomingdale's Department store); he had been in construction (he was a civil engineer), and he was also an expert in real estate management.

Here's what my dad told me: "Stay out of the retail business. The hours are too long, and you're dealing with every darn variable under the sun. Stay out of real estate; when hard times arrive real estate comes to a dead stop and then it collapses. Furthermore, real estate is illiquid. Get into manufacturing; make something people can use. And make something that you can sell to the world. But my boy, if you're seriously interested in making money, get into the money business. It's clean, you can use your brains, you can get rid of your inventory and your mistakes in a minute, and your product, money, never goes out of style."

So much for my father's wisdom (which was obviously tainted by the Great Depression). But he was a very wise man. For my own

part, I've been in a number of businesses -- from textiles to book publishing to owning a night club to the investment advisory business (and I'm now in the process of starting a new business, which I hope to tell subscribers about before this year is out).

Along the way I spent a lot of time and thought in working up the criteria for what I called the IDEAL BUSINESS. Now obviously, the ideal business does not exist and probably never will. But if you're about to start a business or go into someone else's business or want to buy a business, the following list may help you. The more of these criteria that your new business or new job possesses, the better off you'll be.

(1) The ideal business sells the world, rather than a single neighborhood or even a single city or state. In other words, it has an unlimited global market (and today this is more important than ever, since world markets have now opened up to an extent unparalleled in my lifetime). By the way, how many times have you seen a retail store that's been doing well for years -- then another bigger and better retail store moves nearby, and it's kaput for the first store.

(2) The ideal business offers a product which has an "inelastic" demand. Inelastic refers to a product that people need or desire -- almost regardless of price.

(3) The ideal business sells a product which cannot be easily substituted or copied. This means that the product is an original, or at least it's something that can be copyrighted or patented.

(4) The ideal business has minimal labor requirements (the fewer personnel, the better). Today's example of this is the much-talked about "virtual corporation." The virtual corporation may consist of an office with three executives, where literally all manufacturing and services are farmed out to other companies.

(5) The ideal business enjoys low overhead. It does not need an expensive location; it does not need large amounts of electricity, advertising, legal advice, high-priced employees, big inventory, etc.

(6) The ideal business does not require large cash outlays or major investments in equipment. In other words, it does not tie up your capital (incidentally, one of the major reasons for new-business failure is undercapitalization).

(7) The ideal business enjoys cash billings. In other words, it does not tie up your capital with lengthy or complex credit terms.

(8) The ideal business is relatively free of all kinds of government and industry regulations and strictures (and if you're now in your own business, you most definitely know what I mean with this one).

(9) The ideal business is portable or easily moveable. This means that you can take the business (and yourself) anywhere you want -- Nevada, Florida, Washington, Texas (none have state income taxes) or even Monte Carlo or Switzerland.

(10) Here's a crucial one that's often overlooked: the ideal business satisfies your intellectual (and often emotional) needs. There's nothing like being fascinated with what you're doing.

(11) Another important one: the ideal business leaves you with free time. In other words, it doesn't require your labor and attention 12, 16 or 18 hours a day (my lawyer wife, who leaves the house at 6:30 AM and comes home at 6:30 PM and often later, has me well aware of this one).

That's it. If you use this list it may help you cut through a lot of nonsense and hypocrisy and wishes and dreams regarding what you are looking for in life and in your work. None of us own or work at the ideal business. But it's helpful knowing what we are look for and dealing with. As a buddy of mine once put it, "I can't lay an egg, but I know what a great omelet looks like and tastes like."

**GOLD THAT YOU OWN:** This nation's war on gold continues. The Nov. 4 *WSJ* reports that the US Custom Service is considering a 7.8% import duty on certain gold bars produced overseas. Gold industry officials said this could "devastate" the domestic gold industry. Said John Lutley, President of the Gold Institute, *"This is the craziest, most absurd proposal I have ever seen."* **Russell comment**: Increasingly I am opting for actual ownership of gold coins. I don't mean gold in a fund, or gold held at a dealer or gold in a brokerage account. I mean paid-up gold coins in a place where you can put your hands (and nobody else's) on them. As the dollar weakens and the bear market continues, I'm thinking that the war against gold will intensify.

**GOLD and the US FUTURE:** This section is going to be more than simply a gold discussion. In the following I'm going to give my views of what lies ahead for this nation.

But first, in order to get a glimpse of the future, it's necessary to go into some of the mysteries of US government finance. In 1970 federal spending consumed about 20% of this nation's total GDP. This year the figure is nearer 30%. Again, in 1963 so-called "entitlement programs" ate up 29% of all government spending. Interest on the national debt consumed another 6.9%, leaving a large 70.4% for discretionary spending.

But the picture has changed -- drastically. By 1993 entitlement spending hit $864 billion or **61.5%** of the total federal budget. Interest on the federal debt took 14.1%, leaving **only 24.4% for discretionary spending**. How about the future? By 2003 entitlement spending will eat up 72% of the entire US budget, interest will eat up 13.8%, leaving a mere 14.2% for discretionary spending.

So the US faces a number of incredible problems: (1) Federal deficits are continuing to the tune of roughly **$300 billion** a year, while at the same time the national debt pushes ever-closer to **$5 trillion.** (2) A few years from now the federal deficits are slated to accelerate upwards again, and rising interest rates will add tens of billions of dollars to the total. (3) Entitlements (mainly Social Security, Medicare and Medicaid) are eating this nation up alive. Add interest costs, and there isn't a hell of a lot left for discretionary spending. Washington keeps coming up with new spending plans, but there's no money for new spending. There isn't enough money for the old spending.

For your interest and edification, please study these entitlements and their costs in 1994: Social Security -- $317 billion; Medicare -- $158 billion; Medicaid -- $84 billion; unemployment compensation -- $27 billion; food stamps -- $27 billion. And every one of these entitlements has a huge constituency following behind them. Politicians are afraid to even hint at cutting any one of them.

It's clear (at least it is to me), that federal deficits and rising entitlements and interest costs are moving the US towards bankruptcy. **Something has got to give.** What's it going to be?

**Answer:** There is no magic, painless solution. The fact is that one or more of the above items **MUST BE CUT.** Entitlements (mainly Social Security) must be cut, but can they? Taxes must be raised, but the politics of this is explosive. Or government spending across the board must be cut, and this represents still another daunting political problem.

But here's the crux of it. In the end, any or all of these "solutions" will lead to **deflation**. You can't cut spending, you can't raise taxes, you can't cut entitlements without deflationary implications. This then, is the **"deflation time bomb"** that is ticking away in America.

As older subscribers well know, I used to think that we could inflate our way out of our debt problems. And I dramatized this with my oft-repeated adage that the US must "inflate or die." I no longer think the inflation half of the equation is possible. Why?

The reason is that the **"bond vigilantes"** (owners of hundreds of billions of dollars of bonds) **will not stand for inflation.** The fact is that the money markets have become huge, and they've become highly sophisticated. So at **any hint of inflation,** the bonds head south and interest rates head up. A collapsing bond market translates into gigantic losses, and that's deflationary. And rising interest rates mean rising costs of doing business, and that too is deflationary. No, there's no way that this nation can inflate its way out of trouble. Maybe we could have done it 20 or even 15 years ago -- but not today.

The fact is that we've built an unbelievable, giant **credit and debt bubble,** and I believe what we're seeing now is the very **early beginning of a collapse of the bubble.** The debt build up, the credit explosion -- it can't be sustained. The pin has been thrust into the debt bubble. And as the air wheezes out of the bubble, we'll feel the hot breath of deflation.

All of this is obviously not occurring in a vacuum. Wise investors, knowledgeable investors from around the world see what's happening. And they're wondering how, in the face of the coming debt collapse, the dollar can hold up (or survive, for that matter). Remember, all that stands behind the dollar is confidence. If confidence goes, the dollar goes. And as you well know, the dollar has been going -- down.

I always test my thoughts and theories against what's happening in the real world. The world of reality in economics is the **market place.** And I'm wondering, is the deflation scenario what's stopping the precious metals from taking off on the upside? And is the deflation scenario what's sending the dollar tumbling to low after low?

I'm afraid that's exactly what's happening. Deflation -- it's the concept that nobody wants to think about or accept. Deflation -- the event that nobody's prepared for. But the fact remains, the US has spent its future. We've been spending it ever since World War II. The US has spent my kids' inheritances and your grandchildren's inheritances. The US has spent itself into a black hole, and I honestly don't know how we're going to get out of it.

What does all of this add up to? I think it adds up to a **primary bear market in the dollar** (with periodic rallies). I think it adds up to a **primary bear market in stocks and bonds** (with periodic rallies). I think it adds up to continuing anger and frustration on the part of the American people as it slowly dawns on them that 50 years of spending the future must end in pain. Americans are just beginning to feel that pain now, and that's what they're so damn angry about.

What do we as investors do? We try to **survive.** The initial reaction (and I'm talking about investors in the US and around the world) is to move out of dollars and into stronger currencies. Which is what's been happening. The yen, the D-mark, the Swiss franc and the British pound have all be moving up strongly against the dollar. Gold has been pretty much forsaken in this early phase as investors exit the dollar. Gold has not really gone down, mind you, it has just been forsaken.

Somewhere ahead it will be seen that if the dollar is a pariah, all fiat (paper) currencies are also suspect. That will bring in gradual and then increasing accumulating of real money -- gold. Right now, today, I advocate mainly accumulating gold coins. Gold, the metal, represent **riskless wealth** -- riskless because gold has **no debt against it** (therefore it can't go bankrupt), and it's wealth that you control (since you own it physically, it's in your possession).

**GOLD ACTION:** As things stand, if gold can't advance above 400 and make persistent upside progress from there, I would guess that gold will simply be a holding proposition. Without the impetus of rising gold prices, many of the gold stocks (particularly the N. Americans) appear to be expensive and without attractive dividend yields to "hold them up."

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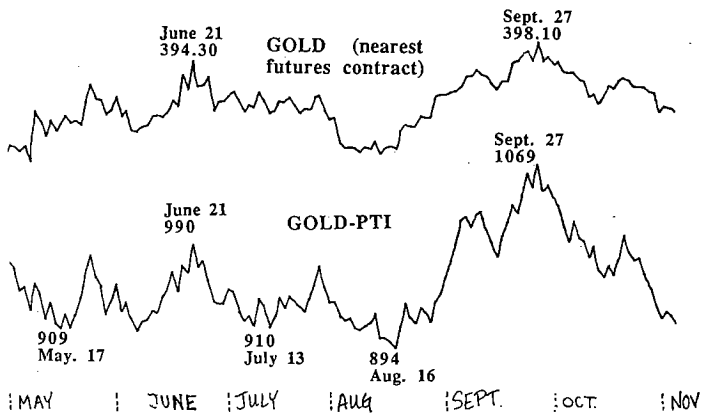
Frankly, the gold picture is now a puzzler. We're dealing with timing, and the market's perception of when the deflationary implications outlined above will materialize. Remember, US finances cannot take real deflation. The dollar cannot survive deflation. If deflation enters the picture, and the giant US debt structure totters, confidence will collapse and so will the dollar.

That in a nutshell is the case for holding gold. And that's my best and most considered view of the future. Gold is money. Gold is intrinsic. Gold can't go bankrupt because it has no debt against it. When you hold gold, you don't need confidence, all you need is time; it's been that way all through history. And it will be that way in the future. The abysmal finances of the US literally guarantee it.

By the way, you wonder why there's so much anguish and anger and disappointment among Americans, even while the economy is still "good." Answer: real wages have been sliding. People, families, can't make it. So they borrow in an attempt to keep up their standard of living. But real wages (wages after inflation) have been declining. That's basically deflationary.

In a recent report, Ed Hyman (*ISI*) lists his reasons why inflation is "low in spite of strong growth": (1) M3 money growth is close to a 30-year low; (2) total credit expansion is close to a 30-year low; (3) government spending is near a 30-year low; (4) money growth, credit expansion and government spending growth is also making, or close to, record lows in the other G-7 countries.




The 895-910 level on the Gold-PTI has offered formidable resistance on the downside, and I would guess that it will continue to do so. We saw peak gold strength on Sept. 27, when the Oct. gold contract hit 398.10 and the G-PTI struck 1069. Since then it's been the "slow slide," with gold acting better than the gold stocks. Gold "feels" reluctant to decline much further. If so, the shares, hopefully, are scraping bottom.

**LATE NOTES:** The stock market has acted as if it has a ten-ton anchor around its neck. The Dow appears to have a bit of bounce in it, but the breadth (i.e., advance-decline ratio) and the PTI continue to record new bear market lows. Joe Granville now counts 880 NYSE issues within one point or less of making new 52-week lows. This is the worst reading yet for the bear market.

Actually, the market has become quite oversold, and my work suggests that it's building up for a rally (possibly after election). Let me put it this way -- if the primary trend was bullish I'd say that the technical position of the market definitely indicated a coming rally, and maybe a good one.

But when the primary trend is bearish (as it now is), it becomes very "iffy" to predict an advance. The tools that worked during the bull market become less dependable or even deceptive when the bear is in command. Which is why I've learned to be rather skeptical of "sold-out" conditions during a bear market (those of you who were with me during 1973-74 know only too well what I'm talking about).

Meanwhile, the bear market losses are adding up -- they're now substantial in the stock market; in the bond market they're horrendous. Poem -- "When in the bear's lair, 'beware, beware'."